Introduction to the Post 2006 Initiative

The milestone of January 1, 2007 (the statutory end of the mandatory transition period and its freeze for bundled electric rates) presents very significant challenges to the Illinois Commerce Commission. The Commission will face a host of questions regarding rate levels, rate structures, and service options that have been on hold due to the limitations of the transition period. The Commission also will continue to serve an essential role in taking steps necessary to maintain the adequacy, safety, and reliability of electric service. Beyond that, however, foremost among the Commission's challenges is to protect customers from the serious problems inherent in a transitioning electricity market in the short-run, while simultaneously providing an environment where competition can be offered the opportunity to mature to the point that such protections are no longer warranted.

The prime legislative finding of the Public Utilities Act is that "the health, welfare and prosperity of all Illinois citizens require the provision of adequate, efficient, reliable, environmentally safe and least-cost public utility services at prices which accurately reflect the long-term cost of services and which are equitable to all citizens."[1] In the Illinois' Electric Service Customer Choice and Rate Relief Law of 1997 (Law), the General Assembly also found that "a competitive wholesale and retail market must benefit all Illinois citizens."[2] The Commission is also charged with the responsibility "to promote the development of an effectively competitive electricity market that operates efficiently and is equitable to all consumers."[3]

To date, the Law has provided tangible consumer benefits through mandated reductions in residential bundled rates and a commercial and industrial customer rate freeze. In addition, some customers, particularly industrial and larger commercial customers in more urban higher-cost service territories, have been able to achieve savings by switching to delivery service tariffs, obtaining their electric supply either from the power purchase option or from retail electric suppliers. While these are tangible benefits of the Law, when the rate freeze and mandated rate reductions end, the energy component within bundled service rates and the price of energy to retail access customers will then be determined by the wholesale marketplace.

The reasons for this change of circumstances are straightforward. Illinois utilities have divested almost all of their generating capacity to unregulated affiliates or other unaffiliated entities. Utilities in Illinois now generate little or no power, but they continue to buy back power from their previously-owned generating units. Most of the power purchase agreements entered into between utilities and the new owners of their former generation will terminate at the same

[1] 220 ILCS 5/1/102
[2] 220 ILCS 5/16-101A (d)
[3] Ibid.

time as the rate freeze. Those independent or affiliated owners have no regulatory or statutory obligation to supply power to Illinois consumers and the Commission has no authority over the price of wholesale electricity sold to utilities for resale (those contracts being under federal jurisdiction) or of electricity sold directly to retail customers via delivery service tariffs. The ultimate costs of power and energy to bundled customers will be based on prices arrived at through negotiations between utilities and generation owners in the wholesale market. While the ability to take service from a competitive supplier (even another utility) operates as an additional check on improper pricing, but the price of competitive retail service is affected by the wholesale market price. Thus, the cost of power and energy to retail access customers will also be influenced by market prices.

The Illinois wholesale electricity business in base-load generation is dominated by the owners of generation purchased from Illinois utilities. While significant amounts of new generation have been constructed in Illinois since 1997, most of that generation is gas-fired peaker generation, and it is not now and never will be in direct competition with base load generation capacity formerly owned by Illinois utilities. While imports from other regions, developing regional electric markets, and market monitors all play a role, the Commission should remain concerned about the concentration of generation ownership and any potential for the exercise of market power by utilities or others.

Today's transmission system is a legacy from the previous regime of pervasive regulation of separate, vertically-integrated-utility service territories and was designed not for supporting competition across vast geographic areas, but for helping basically self-sufficient utilities maintain reliability within their own service territories. With generation ownership concentration (particularly generation owned by utility affiliates) the Commission should encourage the development of new transmission facilities, RTOs, and efficient regional energy and capacity markets as a means of promoting a competitive wholesale electric market.

Retail competition does not prevent volatile, and potentially high, wholesale prices from being passed along to retail consumers. Illinois retail customer dependence on the wholesale power generation business is one of the most significant changes created by the Law, and underscores the importance of the development of competition in the wholesale electricity market. Without a competitive wholesale market for electricity, the potential benefits of retail competition will be lost or greatly reduced.

Due to limitations in its jurisdiction and authority, the Commission must rely on the Federal Energy Regulatory Commission ("FERC") to ensure reasonable prices in the wholesale electricity market and adequate provision of open access transmission service. FERC is currently developing an internal capacity for market monitoring and is establishing independent market monitors with limited market mitigation authority in each organized regional market. These new FERC programs have only a very limited track record and it not at all clear whether the new programs will be adequate or whether FERC may have to revert to direct price regulation of electricity (using either traditional or performance-based approaches). It is also unclear how forcefully the FERC will act to guarantee that transmission capacity will be sufficient to support a competitive market for electricity.

Development of robust wholesale competition would clearly be the ideal solution to the potential problems ahead. However, there is no guarantee that robust wholesale competition will develop under the current statutory approach in Illinois by January 2007 or any time soon thereafter. If not, then high wholesale electricity prices might be attributable to the market power of sellers as long-term contracts expire. The general outlook is for significant over-capacity to persist in the wholesale market for some years beyond 2007, but a significant portion of that capacity has been generation built in the past few years following Illinois restructuring. Market power of generators may allow high prices to exist despite the over-capacity. Under the right conditions, high wholesale prices can be self-correcting due to entry by new firms in both wholesale and retail markets, and due to price-responsive demand. However, such corrections, even if feasible, may take significant time. In addition, mutually beneficial power purchase arrangements between utilities and affiliated generators, exacerbated by transmission power-import constraints which require Illinois utilities to obtain significant amounts of capacity from generation located in traditional service territories, could result in Illinois retail customers paying significantly more at retail for their electric power than a competitive wholesale market would justify. Given the California experience, a valid concern is that customers could be worse off under restructuring than under traditional regulation. If, as in California, it is perceived that competition is not producing the promised benefits of lower prices and customer choice, there is the potential for restructuring to be permanently derailed, or at least hamstrung in its continued development before its potential benefits can be realized.

Significant challenges face the Commission. The first challenge is to encourage the development of a competitive wholesale market, given the problems potentially created by highly concentrated generation markets and the current transmission constraints. Unfortunately, the Commission's ability to have a significant and positive effect in that effort is limited under the current Illinois statutory approach because that framework relies heavily on FERC to take action to protect retail customers through controls on the wholesale market rather than taking necessary statutory steps at the state level to effectively restructure the market. A second challenge is to minimize the price impact on retail customers of a noncompetitive wholesale environment. A third challenge is to design bundled retail service offerings and service options providing appropriate price signals and demand response.

The proposition stated above is intended as a catalyst for issue discussions in workshops that are intended as the first steps in exploring the concerns and challenges facing the State of Illinois in the period between now and 2007. Workshops will focus on issues identified with regard to the form that electric utility service will take after 2006. The following list of issues is intended as a starting point for those discussions, and will be expanded and modified as required to identify the concerns of stakeholders.

The Post 2006 Issues

1. Power Procurement After 2006

The State's largest utilities own very little generating capacity due to the transfer or sale of their generating facilities to unregulated affiliates or other entities. These transfers and sales were accompanied by power purchase contracts, enabling the utilities to purchase a sufficient amount of power and energy to satisfy their bundled customers' energy requirements. Most or all of these contracts will expire by 2007, and utilities will need new supply sources after that date.

As described above, there is concern that customers could be harmed if utilities purchase power and energy for their customers from wholesale markets that are not fully competitive. There is also concern that utilities will, to the detriment of their retail customers, grant preferential consideration to their generating affiliates as their main supply sources. Given these concerns, the central power procurement issue is protection of retail electric customers. The Commission should provide guidance and direction to utilities regarding how they should conduct their supply acquisition activities.

1) Should utilities procure power for bundled customers through auctions, competitive bidding or similar acquisition processes? How would the auctions, competitive bidding, or other acquisition process be structured?
2) Should power acquisition practices be structured any differently where wholesale markets are not fully competitive?
3) As part of the power acquisition process, should utilities be required to file energy plans? What information should be provided? What role would this information play in ratemaking and/or prudence review of costs?

One way to protect customers from volatile wholesale markets would be require or permit utilities to use financial markets to hedge against future wholesale price increases.

4) Should utilities use financial markets to hedge their purchases for their bundled customers? How should hedging costs be recovered in utility

rates? How would prudence be determined for hedging efforts and costs?

As noted above, utilities rely to a great extent on their generating affiliates as supply sources. There is concern that reliance on a limited number of supply sources could potentially restrict the development of wholesale markets.

5) Should the utilities be required to use multiple supply sources rather than relying on a single source? Should energy purchased through any of these methods be acquired in small units or in large blocks? Why?
6) Should utilities be allowed to make any or all of their purchases through an unregulated affiliate? Why or why not?
7) What additional safeguards, if any, should be included in purchase agreements and intercompany operating agreements between a utility and its affiliates?

2. Rate Options After 2006

Provisions in the Customer Choice Law have prevented electric utilities from seeking rate increases and the Commission from initiating rate reviews during the mandatory transition period. Due largely to these provisions, bundled rate levels (except for residential rate reductions) and rate structures have not changed for a decade or more. It is likely that new rate cases will be initiated for most or perhaps even all utilities during 2006, in time for new rates to become effective in 2007. These rate cases will provide an opportunity to consider whether existing rate levels, rate structures, and service options provided by utilities are appropriate in light of the numerous changes that have taken place in the Illinois electric industry since 1997.

Some utilities, however, may be satisfied with the current level of rates, if, for example, wholesale electric rates are expected to be lower than the generation-related component embedded in bundled rates.

8) Should the Commission initiate rate proceedings for each electric utility prior to 2007?

One basic question is whether customer bills should be unbundled, so that all customer bills would show the charges for generation, distribution and transmission, etc. A related question is whether each utility should have the same classes for both delivery services customers and customers purchasing their power and energy from the utility.

9) Should rates be determined, and shown on the tariff sheets, for both bundled and delivery services, as individual rate components, in a manner such as: customer charge, meter charge, distribution delivery charge, transmission delivery charge, and supply charge? If so,

should there be a single proceeding to reset the delivery component that would apply to both bundled rates and delivery service?

10) Should each individual utility have the same customer classes for both bundled and unbundled customers?

Perhaps the major rate issue with respect to rates in a post-transition period is how generation costs will be passed along to those customers that do not choose alternative suppliers, now that the State's largest utilities procure virtually all of their power from the wholesale market. Several options are apparent. Prior to the rate freeze, rates were typically ordered into effect for an indefinite period until the Commission ordered new rates into effect. One alternative going forward is to fix rates for a specified, relatively lengthy period. Alternatively, rates could be based on a relatively current measure of market value and perhaps would be reset frequently. If rates were to be based on market indices, one question that would arise is whether current market value estimation methods would need to be modified in some manner.

Another alternative would be to allow utilities to recover purchased power costs through a uniform fuel adjustment clause ("UFAC") mechanism. If a UFAC mechanism were an appropriate cost recovery mechanism, it might then be necessary to examine whether existing UFAC rules (83 Ill. Adm. Code 425, Uniform Fuel Adjustment Clause) would adequately address all relevant cost recovery issues in a restructured industry.

11) Should rates be reset on a monthly or yearly basis or should rates be fixed for a multi-year period? Or, should an assortment of these products be made available?
12) Should the cost of power be determined as a fixed amount in base rates from rate case to rate case?
13) Should some or all customer rates reflect market indices? How would costs be recovered if some rates were to reflect market indices? Should new market value estimation methods be developed if rates are to be based on market indices? What, if any, are the uses for the Neutral Fact Finder processes in the post-2006 period?
14) Should 83 Ill. Adm. Code 425 be modified to address demand costs, transmission costs, interest, and reinstatement of a fuel adjustment clause after the end of the mandatory transition period? Should the Commission develop rules for a new purchase power clause?
15) Should Ill. Adm. Code 425 be modified to reflect the "new" significant role of purchased power in energy costs?
16) Should some or all rates, or individual components of rates, for some or all of the rate classes be determined on a seasonal basis?
17) Should rates for customers who return to bundled service be different from rates offered to basic bundled service customers? Do customers who move back and forth between bundled services and delivery

services cause additional costs that should be charged only to those customers?

Another issue is the type of rate options that utilities will offer after 2006. With the expiration of the mandatory transition period, utilities may wish to eliminate existing rate options or to offer new tariffs.

18) What new rates or services, if any, should utilities offer (e.g., green power options)?
19) Should there be an interruptible rate option for transmission and distribution services and/or generation services? How should such rates be designed?

Thousands of customers have opted to take service under Power Purchase Option ("PPO") tariffs offered by the utilities that have charged transition charges to delivery services customers. Provisions in Sec. 16-110 appear to indicate that some utilities may be required to offer PPO service after the end of the mandatory transition period.[4] However, the price for PPO service and the terms and conditions under which such services must be offered after 2006 may be different than the prices, terms and conditions in under current PPO tariffs.

20) What are the circumstances under which PPO must be offered subsequent to the end of the mandatory transition period? How should Sec. 16-110 provisions be implemented by the utilities that are required to offer PPO service after 2006? How should rates for the post-2006 PPO be structured?

It is frequently argued that significant customer use of real-time pricing tariffs could have beneficial effects on system reliability, dampen wholesale prices, and perhaps defer the need for new generation facilities. All electric utilities were required by the by Sec. 16-107 to offer real-time pricing tariffs, but very few customers have taken advantage of these tariffs.

21) Should existing real-time tariffs be modified to encourage customer interest in such tariffs? If so, how? What will be the impact on real-time customers resulting from the elimination of the transition charges?

3. Competitive Issues

The Commission's reports to the General Assembly on the progress of competitive markets has indicated that competitive activity has been limited primarily to the largest customers in the State's largest service areas. Additionally, supplier interest in smaller markets has been very small. In fact, no seller has even applied to provide retail electric service to residential customers. However, the prospect for competition may receive a boost after 2006, when the

[4] See, for example, Sec. 16-110(c) and Sec. 16-110(d).

utilities presently charging transition charges may no longer charge such fees to customers taking service from alternative suppliers.

The questions in this section concern the actions that could be undertaken to stimulate competition.

22) What measures should the Commission undertake to encourage retail competition for smaller-use customers?
23) What measures should the Commission undertake to encourage competition in the service areas of the State's smallest utilities?
24) What role could municipal aggregation programs play in encouraging retail competition among smaller-use customers?
25) What barriers to participation in the market can and should be removed?
26) Should regulations regarding codes of conduct and utility-affiliate activities be modified?
27) What further progress can be made towards uniform tariffs?

List of Issues

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